IT 00-3
Tax Type: Income Tax
Issue: Apportionment: One Factor/Three Factor Application Issues

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 95-IT-0000**
	FEIN: 00-0000000
	Tax yr.: 1988 & 1989
v.	
	Charles E. McClellan
"LPN PIPELINE COMPANY", Taxpayer	**Administrative Law Judge**

RECOMMENDATION FOR DECISION

Appearances:

Ralph P. Bassett, Jr. and Deborah H. Mayer for the Department of Revenue; Fred Ackerson of D'Ancona & Pflaum for the taxpayer.

Synopsis:

This matter involves a Notice of Denial ("NOD") issued by the Department to "LPN Pipeline Company" and its affiliates ("LPN"or "taxpayer") on May 18, 1995 on refund claims filed by "LPN" for calendar years 1988 and 1989. The NOD allowed a portion of taxpayer's claims and denied the remainder. A pre-trial order was entered on November 20, 1998, setting forth the issues.

An evidentiary hearing was set for February 11, 1999 and continued to April 28, 1999 on motion of the Department. At the hearing the parties presented a stipulation of facts but called no witnesses. The list of issues set forth in the pre-trial order was modified in the stipulation so that the issues remaining for decision are as follows:

1. Whether the distributive shares of the income and apportionment factors of certain partnerships owned by "LPN" (*viz*. "Frozen Tundra Pipeline System" ("FTP"), "Ashram Pipeline", "Elsewhere Pipeline", "Kodiak Transportation", and "Pestalozzi Pipeline"), should be included with the apportionment of the unitary business income to "LPN"'s unitary business group pursuant to 86 Admin Code ch. I, § 3700(d), renumbered as 100.3380(c), or as taxpayer asserts, should the partnerships' income be apportioned under Illinois Income Tax Act § 305.[1] Stip. ¶ 40 a.
2. Whether as "LPN" asserts, Reg. § 100.3380(c) is invalid, and whether "LPN" did not have sufficient control over the partnerships for the income and factors to be included in "LPN's" unitary business. *Id*. at ¶ 40 b.
3. Whether, as "LPN" asserts, Public Act 82-1029, which enacted IITA § 1501(a)(27), is unconstitutional and invalid because it was enacted by an improper use of the amendatory veto power in violation of Ill. Const. art. IX, § 9(e). If the foregoing is correct, "LPN" further asserts that the Department could not utilize the unitary business method of apportionment, nor include in a single unitary business group the income and apportionment factors of "LPN's" interests in the pipeline activities and partnerships located wholly outside of Illinois and the income and

[1] Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq*., the Illinois Income Tax Act ("IITA" or the "Act"). The regulations 86 Admin Code ch. I, § will be referred to as Reg. § n, e.g., "Reg. § 100.3700(d)" and "Reg. § 100.3380(c)".

apportionment factors of “LPN’s” pipeline activities located in Illinois. *Id*. at ¶ 40 c.

Following the evidentiary hearing both parties filed briefs. My recommendation is that the Department’s Notice of Denial of part of taxpayer’s refund claim be made final.

Findings of Fact:

1. “LPN” Pipeline Company is a “Somewhere” corporation with its corporate domicile in (Another State). Stip. ¶ 1.
2. “LPN’s” principal business is transportation of crude oil by pipeline in the United States, including in Alaska and Illinois. Stip. ¶ 2.
3. During the years at issue, “LPN” owned a 5% interest in “Kodiak Transportation Company” (“Kodiak”), a general partnership that owned and operated a pipeline system located in Alaska. Stip. ¶¶ 3, 27.
4. “Kodiak’s” system includes a 24 inch pipeline approximately 27 miles long which is used to transport crude oil from the “Kodiak” River oil field in northern Alaska to “FTP” Pump Station No. 1 in the Prudhoe Bay oil field from where the oil is transported across Alaska in the “Frozen Tundra Pipeline System” (“FTP”). *Id*.
5. During the years at issue, “LPN” was one of three general partners of “Kodiak”, the other owners being “ABC Corp.” (38%) and “DEF Company” (57%). Stip. ¶ 28.
6. An affiliate of “DEF” was the operator of “Kodiak”. *Id*.
7. The “Kodiak” partnership agreement provided that the business of the partnership would be managed by a committee consisting of representatives of each of the general partners, and that actions of the committee generally could be approved by

the affirmative vote of two or more partners whose combined ownership interest equaled at least 75%. Stip. ¶ 29.

8. During the years at issue, “LPN” owned a 10.5174% interest in “Elsewhere Pipeline Company” (“Elsewhere”), a general partnership that owned and operated a pipeline system located in Alaska. Stip. ¶¶ 3, 31.

9. The other general partners and their percentage of ownership were “PDQ Corporation” (21%), “XYZ, Inc.” (57%), and “RJS Corporation” (10%). Stip. ¶ 32.

10. An affiliate of “XYZ, Inc. operated “Elsewhere”. *Id*.

11. “Elsewhere’s” system includes a 16 inch pipeline approximately 27 miles long which is used to transport crude oil from the “Elsewhere” oil field in northern Alaska to “FTP” Pump Station No. 1 in the Prudhoe Bay oil field from where the oil is transported across Alaska in the “FTP” system. *Id*.

12. The “Elsewhere” partnership agreement provided that the business of the partnership would be managed by a committee consisting of representatives of each of the general partners, and that actions of the committee generally could be approved by the affirmative vote of two or more partners whose combined ownership interest equaled at least 65%. Stip. ¶ 33.

13. Because “LPN” owned in excess of 10% of “Elsewhere”, “LPN” had the capacity to block certain actions by the partnership, to wit: (1) incurring partnership indebtedness, (2) selling, leasing or otherwise disposing of all or substantially all of the partnership’s property or assets, (3) acquisition or holding title to property other than in the name of the partnership, (4) approval of an expansion, extension or

other capital project costing more than $20 million (subject to adjustment), and (5) dissolution of the partnership. Stip. ¶ 34.

14. During the years at issue, “LPN” owned a 4.46429% % interest in “Ashram Pipeline Partnership” (“Ashram”), a general partnership that owned and operated a pipeline system located in California. Stip. ¶¶ 3, 36.

15. The other general partners in the “Ashram” partnership and their percentage of ownership were “IUD Pipeline Company” (22.32%), “LMN Petroleum Company” (20.09%), “ARM Pipeline Company” (an affiliate of “Ashram”) (13.39%), “JUZ Pipeline Company Inc.” (11.61%), “CRE Oil Pipeline Company” (an affiliate of “PJS Oil Company”) (8.18%), “SOT Company” (7.00%), and “FQY Pipeline, Inc.” (5.80%). Stip. ¶ 37.

16. “IUD Pipeline Company” operated “Elsewhere”. *Id*.

17. “Ashram’s system includes a 24-inch pipeline approximately 26 miles long that is used to transport crude oil from the Platform Hermosa off Point Conception, California to an onshore processing plant near Gaviota, California. *Id*.

18. The “Ashram” partnership agreement provided that the business of the partnership would be managed by a committee consisting of representatives of each of the general partners, and that actions of the committee generally could be approved by the affirmative vote of two or more partners whose combined ownership interest equaled at least 66.66%. *Id*.

19. During the years at issue, “LPN” owned a 22% interest in “Pestalozzi Pipeline Partnership”, a general partnership that owned a pipeline system in California. Stip. ¶ 3.

20. During the years at issue, “LPN” owned a 1.3651% interest in “FTP, a general partnership that owned a pipeline system in Alaska. Stip. ¶¶ 3, 13.

21. The other owners of “FTP” were affiliates of “PDQ Corporation” (20.34%), “XYZ, Inc.” (50.02%), “Ashram Company” (21.35%), “FUZ Corporation” (4.08%), “OYE Corporation” (1.50%), and “LMN” Petroleum Company (1.36%). Stip. ¶ 14.

22. “FTP” consists primarily of a pipeline system that includes a 48 inch pipeline approximately 800 miles long that is used to transport crude oil from the Prudhoe Bay oil field on the north slope of Alaska across Alaska to the port of Valdez. Stip. ¶ 13.

23. “FTP” also operates related terminal facilities, pumping stations and other equipment. *Id*.

24. The owners of “FTP” executed the “Frozen Tundra Pipeline System Agreement” dated August 27, 1970, by which they agreed to construct, own and maintain “FTP”. Stip. ¶ 15.

25. The operation of “FTP” was governed during the years at issue by the terms of a document entitled Agreement for the Operation and Maintenance of the “Frozen Tundra Pipeline System” that the partners entered into on May 20. 1977 (“FTP” Operating Agreement”). Stip. ¶ 16.

26. During the audit period, the “FTP” Operating Agreement provided for an Owners Committee (“committee”) composed of one representative of each of the owners of the “FTP” system. Stip. ¶ 17.

27. All actions of the committee required a vote of at least three owners’ representatives representing at least 66 2/3 % of the ownership. *Id*.

28. The "FTP" operating agreement provided that the committee would: approve budgets, approve the acquisition in the name of the owners of land rights, materials, supplies and services as required through budget approval; approve all manuals referred to in the operating agreement; approve settlement of claims, initiation of lawsuits, etc., under the criteria specified in the operating agreement; approve the disposal of material, equipment and facilities pursuant to the provisions of the operating agreement which provides, in part, that a sale by any means of any items of materials, equipment or facilities having a purchase price or an appraised fair market value of $1,000,000 or more must be approved in advance by the owners through the owners committee; establish standards and procedures for connections to the pipeline system; and exercise such other authorities and powers as are delegated in the agreement. Stip. ¶ 18.

29. The "FTP" operating agreement provided that the committee would select an operator to operate and maintain "FTP". Stip. ¶ 19.

30. The owners committee selected "ROS Pipeline Service Company" ("ROS") as operator of the pipeline system, and "ROS" managed the operations of "FTP" during the audit period. *Id*.

31. "ROS" is a corporation that is owned by the companies that own "FTP" in the same proportion as their ownership of "FTP". *Id*.

32. Each of the owners of "FTP" had the obligation to conduct the operation of its undivided interest in the pipeline as a common carrier to the extent of its interest in the pipeline. In this capacity, each owner would (a) publish and file tariffs in its own name, (b) separately solicit and receive tenders of petroleum from shippers, (c)

separately arrange for the shipping of the petroleum and (d) separately collect and account for revenues from its own pipeline shipments. Each of the owners of "FTP" was responsible for scheduling its own shipments through the pipeline and for scheduling ships to take the oil at the Port of Valdez terminal. Stip. ¶ 20.

33. "LPN" sent a representative, "John Doe", to all of the meetings of the owners committee during 1988 and 1989. Stip. ¶ 21.

34. Each owner of "FTP" appointed one member to the "FTP" construction committee. Stip. ¶ 22.

35. Each owner of "FTP" had the right to require that additional storage capacity be constructed. *Id*.

36. In the event of a transfer of ownership in "FTP", each owner had the right to purchase the interest before it could be sold to a party outside the current ownership, and a sale of more than 5% had first to be approved by either a majority of the owners or else the consent of owners holding at least 66 2/3% interest in "FTP". Stip. ¶ 23.

37. "LPN" and all of the partnerships are in the "pipeline" business. Stip. ¶¶ 3, 24, 30, 35, 38.

38. All of the partnerships are partnerships for federal and Illinois income tax purposes. Stip. ¶ 3.

39. All of the partnerships, except "FTP" filed partnership information tax returns with the Internal Revenue Service. *Id.*

40. "FTP" received a ruling from the Internal Revenue Service that "FTP" was a partnership for federal income tax purposes and that the owners could make an

election under Section 761(a) of the Internal Revenue Code allowing it to be treated as a "flow through" entity not required to file a federal information tax return but requiring each partner to take into account it's distributive share of the items of income, gain, loss, deduction or credit of the partnership. *Id.*, Stip. ¶ 25.

41. "LPN's" distributive share of income from these partnerships is business income. Stip. ¶ 4.

42. "LPN" filed its Illinois income tax returns for 1988 on a separate basis as a single corporation. Stip. ¶ 5.

43. "LPN" filed its Illinois income tax returns for 1989 on a combined unitary basis with "MLE Pipeline Company". *Id*.

44. In its Illinois income tax returns for 1988 and 1989, "LPN" included its distributive share of income from each of these partnerships in its combined apportionable business income. *Id*.

45. In its Illinois income tax returns for 1988 and 1989, "LPN" included its share of the "FTP" partnership apportionment factor in the denominator of its Illinois apportionment factor but excluded its share of the apportionment factors of the other partnerships from its Illinois apportionment factor. *Id*.

46. "LPN" filed amended Illinois income tax returns for 1988 and 1989 in which it excluded from its Illinois apportionable base its distributive share of partnership business income from "FTP", "Kodiak", "Elsewhere" and "Ashram". Stip. ¶¶ 6, 7.

47. "LPN" also excluded from the denominator of its apportionment factor its distributive share of the factors from "FTP", "Kodiak", "Elsewhere" and "Ashram". *Id*.

48. The correct amount of income or loss from these partnerships and the amount which "LPN" excluded from its amended returns is as follows:

	1988	1989
"FTP"	$21,140,431	$15,111,788
"Kodiak" Transportation Co.	$2,993,588	$3,065,208
"Elsewhere" Transportation	$2,223,204	$1,965,271
"Ashram"	($677,036)	($827,957)

Id.

49. "LPN's" share of barrel miles from these partnerships and the amount which "LPN" excluded from the denominator of its apportionment factor is as follows:

	1988	1989
"FTP"	7,952,757,450	7,359,389,946
"Kodiak" Transportation Co.	181,201,175	182,413,314
"Elsewhere" Transportation Co.	103,742,568	101,022,619
"Ashram"	0	0

Id.

50. "LPN" did not exclude any of the income or barrel miles attributable to "Pestalozzi Pipeline Partnership". *Id*.

51. The Department disallowed $259,905 of "LPN's" claim of $264,907 for 1988 and allowed $5,002 of that claim. Stip. ¶ 9.

52. The Department disallowed $185,477 of "LPN's" claim of $189,927 for 1989 and allowed $4,450 of that claim. *Id*.

Conclusions of Law:

The first issue to be decided is whether the income of the partnerships in which "LPN" is a partner (*viz*. "Frozen Tundra Pipeline System" ("FTP"), "Ashram" Pipeline, "Elsewhere" Pipeline, "Kodiak" Transportation, and "Pestalozzi Pipeline") should be apportioned at the partnership level under Section 305, as asserted by "LPN", or whether "LPN"'s distributive shares of the income and apportionment factors of these partnerships should be included in "LPN's" unitary business income and be apportioned under Section 304 and Reg. § 100.3700(d), renumbered as Reg. § 100.3380(c). The parties stipulated that "LPN" and the partnerships are in the "pipeline" business (Stip. ¶¶ 3, 24, 30, 35, 38) and that "LPN's" income from the partnerships is business income. (Stip. ¶ 4) The parties also stipulated that "LPN" is a non-resident corporation that conducts its pipeline transportation business in Illinois, Alaska and other states. (Stip. ¶¶ 1, 2) The parties do not dispute that pipeline companies apportion their income using a single factor consisting of revenue miles in Illinois as a percentage of revenue miles everywhere as required by IITA § 304(d)(2).

In its post-hearing brief, "LPN" presents alternative arguments. First, it argues that IITA § 305 controls the apportionment of income and factors from the partnerships, and, to the extent that, Reg. § 100.3880(c) does not follow the statutory scheme of IITA § 305, the regulation is invalid. Second, "LPN" argues that because it did not have a controlling interest in any of the partnerships, no unitary business relationship could exist with respect to them and "LPN" under the doctrine set forth in cases such as F. W. Woolworth Co. v. Taxation and Revenue Department of the State of New Mexico, 458 U.S. 354, 102 S. Ct. 3128 (1982); ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S. Ct. 3103 (1982); and Allied-Signal, Inc. v. New Jersey Division of Taxation, 504 U.S. 768 (1992). Third, "LPN" argues that the combined method of apportionment for unitary business groups cannot be applied at all, because the legislation enabling the combined method in Illinois, Public Act 82-1029 (1982) is invalid due to an improper amendatory veto.

"LPN's" first argument is that "Section 305(a) requires that the business income of every partnership must be 'apportioned to this State in the possession of the partnership,' and shall be taken into account by the partners in accordance with their respective distributive shares." IITA § 305 provides, in relevant part, as follows:

> Allocation of Partnership Income by partnerships and partners other than residents.
> (a) Allocation of partnership business income by partners other than residents. The respective shares of partners other than residents in so much of the business income of the partnership as is allocated or apportioned to this State in the possession of the partnership shall be taken into account by such partners pro rata in accordance with their respective distributive shares of such partnership income for the partnership's taxable year and allocated to this State. . . .
> (c) Allocation or apportionment of base income by partnership. Base income of a partnership shall be allocated or apportioned to this State pursuant to Article 3, in the same manner as it is allocated or apportioned for any other nonresident.
> 35 ILCS 5/305.

Under "LPN's" theory, the partnerships would apportion their income under the provisions of Section 305, the result of which would be that none of "LPN's" share of partnership income would be apportioned to Illinois. "LPN's" reliance on the language of Section 305 is misplaced. Section 305 deals with the apportionment of partnership income by a non-resident partner. It does not deal with the apportionment of the business income of a unitary group of corporations, one of which owns an interest in partnerships the activities of which make them integrated parts of the unitary business activities of its partners, as is in the instant case.

Section 304 deals with unitary business groups and it requires members of a unitary business group to use combined reporting to apportion the groups' base income. IITA §

304(e). The phrase "unitary business group" is defined in Section 1501(27), in part, to mean "a group of persons related through common ownership whose business activities are integrated with dependent upon and contribute to each other." Section 1501(a)(18) defines the word "person" to include an individual, a trust, estate, partnership, association firm, company, corporation, limited liability company, or fiduciary." Section 1501(a)(27) also provides that "Common ownership in the case of corporations is the direct or indirect control of ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity." By its own terms, the 50% ownership provision only applies to corporations. Thus, a partnership can be part of a unitary group although the unitary group does not own 50% of the partnership.

Section 304, which is contained in Article 3 of the IITA and requires combined apportionment by unitary business groups, provides, in relevant part, as follows:

> Business income of persons other than residents.
>
> (a) In general. The business income of a person other than a resident shall be allocated to this State if such person's business income is derived solely from this State. If a person other than a resident derives business income from this State and one or more other states, then, except as otherwise provided by this Section, such person's business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any) and 200% of the sales factor (if any), and the denominator of which is 4 reduced by the number of factors other than the sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero.
>
> * * *
>
> (e) Combined apportionment. Where 2 or more persons are engaged in a unitary business as described in subsection (a)(27) of Section 1501, a part of which is conducted in this State by one or more members of the group, the business income attributable to this State by any such member or members shall be apportioned by means of the combined apportionment method. 35 ILCS 5/304.

The key to whether the partnership is part of a unitary group is also addressed in Section 1501(a)(27) which, in part, provides that "Unitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance; . . .." In the instant case, the parties stipulated that "LPN" and the partnerships are engaged in the pipeline business. The partnerships own the pipelines which enable the partners to transport crude oil from Alaska to their pipelines in the lower 48 states, including Illinois, in the case of "LPN". Thus, "LPN's" partnership interest in the partnerships is an integral part of "LPN's" unitary business activities. See Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 435; 100 S.Ct. 1223, 1230. Therefore, under the language of the statute, it is clear that "LPN's" unitary business includes the partnerships to the extent of its partnership interests. As a unitary business group conducting business activities in Illinois and other states, "LPN" is required to apportion its business income, which includes its share of the partnership business income, on a combined basis.

The Department's regulation Reg. § 100.3700(d), renumbered as Reg. § 100.3380(c), also requires that "LPN's" share of the partnership income be apportioned under Section 304. In relevant part, that regulation provides as follows:

> c) Rule for inclusion of shares of partnership unitary business income and factors in combined unitary business income and factors of corporate partners. When the activities of a corporate partner (or the activities of a unitary business group including the corporate partner) and the activities of a partnership, disregarding ownership requirements, constitute a unitary business relationship, then the partner's share of the partnership's income and factors shall be combined with the business income and factors of the partner or with the combined business income and factors of the unitary business group including the partner, as the case may be. The activities of a corporate partner and the activities of a partnership will constitute a unitary

> business relationship when such activities are integrated with, dependent upon, and contribute to each other. However, this subsection (c) will not apply to shares of income from partnerships whose business activity outside the United States is 80% or more of such partnership's total business activity, where the partnership has a different apportionment method than the corporate partner, or where the partnership is not in the same general line of business or a step in a vertically structured enterprise with the corporate partner. This subsection (c) is applicable to all taxable years for which the statute of limitations for filing claims for refund and for issuing notices of deficiency are open, except those tax years ending on or after the effective date (April 24, 1984) of Section 100.9700(e)(2) and ending prior to its repeal where the taxpayer relied upon that subsection.
> 86 Admin Code ch. I, § 100.3380(c).

The record in this case clearly shows that Reg. § 100.3380(c) applies to “LPN” and the partnerships. The parties stipulated that “LPN” and all of the partnerships are in the “pipeline” business and that “LPN” owns a general partnership interest in each of the partnerships. These facts establish that they are in the same general line of business. The record also shows that the pipelines owned by the partnerships are integral to “LPN’s” pipeline business. None of them have 80% or more of their business activity conducted outside of the United States. Therefore, the activities of “LPN” and the partnerships constitute a unitary business relationship under the terms of Reg. § 100.3380(c).

“LPN” notes that the Department’s regulations adopted in 1984 provided that a corporation could not treat a partnership as part of its unitary group unless the corporation owned or controlled all of the partnership interests or all of the general partnership interests in a limited partnership. This regulation was in effect when the legislature amended IITA § 305 in 1985 (Public Act 84-850) without any change in the Department’s position as reflected in that regulation. This regulation, 86 Ill. Admin. Code § 100.9900(e)(2), was repealed in 1987 (11 Ill. Reg. 112410). “LPN” argues that Reg. § 100.3700(d) (renumbered as Reg. § 100.3380(c)) which was adopted in 1987 is, “essentially”, an attempt to repeal IITA § 305 because it is a shift in the Department's interpretation of IITA § 305. "LPN" concludes that the adoption of Reg. § 100.3700(d) was improper and that it should not be applied to the facts of this case.

"LPN" is correct in stating that the adoption of Reg. § 100.3700(d) in 1987 was a departure from its earlier interpretation of IITA § 305. Prior to the adoption of Reg. § 100.3700(d), the Department had interpreted IITA § 1501(a)(28) — the statutory definition of "unitary business group" — to mean that a partnership could be combined into a unitary business group with a corporation which was a partner in the partnership only if each and every partner in the partnership was also a member of the unitary business group. That "all or nothing" rule was set forth in Reg. § 100.9900(e)(2)(i), which was in effect from 1984 until the adoption of Reg. § 100.3700(d) in 1987.

Reg. § 100.9900 provided definitions and illustrations of terms used by the Illinois General Assembly in its definition of the term "unitary business group." Ill. Rev. Stat. ch. 120, ¶ 2-1501(a)(28) (1987). Subsection (e) of that regulation interpreted the term "common ownership", and subsection (e)(2) interpreted common ownership as it pertained to partnerships. Specifically, former Reg. § 100.9900(e)(2) provided:

> Partnerships.
> Under IITA Section 1501(a)(16), a partnership is defined to include joint ventures. For clarity, the rules which follow deal separately with partnerships and joint ventures, though the underlying principles enunciated in the rules for the two types of enterprise are the same. The rules stated below only address whether a partnership is "related through common ownership" to other persons in a group. Even if it is so related, it will only be a member of such group if it meets the other relevant tests.
> A) it employs the same apportionment method as other members,
> B) it has more than 20% of its business activity in the U.S.,
> C) it is under strong centralized management with other members, and
> D) it is in the same general line of business as other members or it is a step in a vertically structured enterprise with other members.

i) Traditional Partnerships.

> A partnership cannot be a member of a unitary business group unless it is "related through common ownership" to other members of the group. IITA Section 1501(a)(28) does not provide a mathematical test for common ownership of partnerships as it does for corporations. (See paragraph subsection (e)(1) above.) These regulations proceed from the premise that the partners are owners of the partnership. Consequently, a partnership is related through common ownership if the group includes all of its partners. If a group of persons includes some, but not all, of a partnership's partners, the partnership will not generally be deemed to be related to the group through common ownership. **. . .**
>
> 86 Ill. Admin. Code § 100.9900(e)(2).

Before Reg. § 100.3700(d) was adopted, and while purporting to allow combination of corporations and partnerships into a unitary business group (*see* Reg. § 100.9900(b)), the Department had interpreted the concept of common ownership in such a way as to virtually assure that no such combinations would ever occur. Ill. Rev. Stat. ch. 120, ¶ 2-1501(a)(28) (now 35 ILCS 5/105(a)(27)). Interestingly, the Department articulated three exceptions to the all or nothing rule, which exceptions would "not preclude" the combination of a corporation and a partnership into a unitary business group. *See* 86 Reg. § 100.9900(e)(2)(i). However, in practice, those exceptions required that someone undertake an extensive examination of the partnership agreements themselves, including an analysis of whether partners named in those partnership agreements (and who did not share common ownership with the corporation) enjoyed the "*usual* rights … to participate in the conduct and control of the partnership business," or whether the general partners to such partnerships had any "*real independent* interest in the management or control of the partnership business …." *Id.* (emphasis added).[2] In other words, even the exceptions to the general rule made it difficult to combine into a unitary business group

[2] There was no hint in Reg. § 100.9900(e)(2)(i) how these vague standards might be implemented.

persons clearly engaged in a unitary business enterprise, simply because the members, or partners, had different forms of business ownership.

The Department's former "all or nothing" rule made it easy to manipulate combined reporting, merely by including an individual as one of the named partners in a partnership agreement. Even assuming that the Department's premise that a partnership is owned by its partners was relevant within the context of combined apportionment (*see* Reg. § 100.9900(e)(2)(i)),[3] no individual partner could *ever* be "related through common ownership" with a corporation with whom it entered into a partnership agreement.

Subsection (d) of Reg. § 100.3700 was a brand new rule, and it was situated within a section of regulations the Department had previously promulgated to articulate special rules interpreting the provisions of 304 of the IITA. 11 Ill. Reg. 12410 (in ¶ 4 of the Department's Notice of Adopted Amendments, the Department identified IITA §§ 304(e), 304(f), and 1401(a) as the statutory authority for the new rule). The new rule corrects the deficiencies in the old rule that was repealed, because it more clearly reflects the interrelationship between IITA §§ 305 and 304, and it interprets those sections so that no language in either section is meaningless or superfluous.

"LPN's" assertions regarding the validity of Reg. § 100.3700(d) are incorrect. IITA § 1401(a) authorizes the Department "to make promulgate and enforce such reasonable rules and regulations . . . relating to the administration and enforcement of the provisions of [the IITA], as it may deem appropriate."

---

[3] The Illinois' Uniform Partnership Act has always provided that a "partner's interest in the partnership is his share in the profits and surplus" of the business being conducted by the partnership. Ill. Rev. Stat. ch. 106½, ¶ 26 (1917) (*now* 805 ILCS 205/26); In re Estate of Johnson, 129 Ill. App. 3d 22, 27 (4th Dist. 1985). So, while it might be said that the partners *own* the partnership, what each partner actually owns is an expectancy interest in the contractual (partnership) arrangement, rather than the contract itself. 805 ILCS 205/26.

The Illinois Supreme Court has considered the scope and nature of the General Assembly's grant of rule making authority to the Department. In Du-Mont Ventilating Co. v. Department of Revenue, 73 Ill. 2d 243, 244-45 (1978), for example, the Illinois Supreme Court wrote,

> The enabling legislation ... authorizes the Department to make, promulgate and enforce reasonable rules and regulations relating to the administration and enforcement of the [ROTA]. The rule merely interprets the scope of the statutory exemption provision and as such it is entitled to some respect as an administrative interpretation of the statute, but it is not binding on the courts. See *Oscar L. Paris Co. v. Lyons*, (1956), 8 Ill. 2d 590, 597-98; *Terrace Carpet Co. v. Department of Revenue*, (1977), 46 Ill. App. 3d 84, 90. Administrative rules can neither limit nor extend the scope of a statute. . . .
>
> Du-Mont Ventilating Co., 73 Ill. 2d at 247.

Although the ultimate arbiter of an agency's interpretation of Illinois law must be an Illinois court, Reg. § 100.3700(d) will be upheld *only if it is* a "reasonable rule[] ... relating to the administration and enforcement of the provisions of [the IITA]." 35 ILCS 5/1401(a); *see also* Texaco-Cities Services Pipeline Co. v. McGaw, 182 Ill.2d at 486 (while not binding on the court, the Department's income tax regulations interpreting the IITA's definition of business income were given "substantial deference"); Dover v. Illinois Department of Revenue, 271 Ill. App. 3d 700, 707-08 (1st Dist 1995) (Department's regulation interpreting IITA was valid when read in conjunction with the Illinois Supreme Court's decision in GTE Automatic Electric v. Allphin, 68 Ill. 2d 326 (1977)).

"LPN" states that the Joint Committee on Administrative Rules opposed the adoption of Reg. § 100.3700(d), citing 11 Ill. Reg. 7462, April 17, 1987. That is not quite correct, however. Before Reg. § 100.3700(d) was adopted, the Joint Committee on Administrative Rules ("JCAR") filed a statement of objections to the original version of the rule. 11 Ill. Reg. 7462-72 (April 17, 1987). When finally adopted by the Department, Reg. § 100.3700(d) had been modified, in part, by adding the second and third sentences "[p]er agreement with JCAR". 11 Ill. Reg. 12411 (¶ 11). In paragraph 11 of the Department's Notice of Adopted Amendment, the Department identified all the modifications to the original version of rule 3700(d). 11 Ill. Reg. 12410-11 (¶ 11 of that Notice is titled: "Differences between proposal and final version [of rule]"). In paragraph 12 of its Notice of Adopted Amendment, to the question: "Have all the changes agreed upon by the agency and JCAR been made as indicated in the agreement letter issued by JCAR?" The Department replied "Yes". 11 Ill. Reg. 12411 (¶ 12). This indicates that the final form of the regulation was approved by JCAR. The adoption of Reg. § 100.3700(d) eliminated the impractical results resulting from the adoption of Reg. § 100.9900 and correctly interpreted IITA § 305 as it relates to IITA § 304 and is valid on its face. For these reasons, Reg. § 100.3700(d), now Reg. § 100.3380(c) is a valid interpretation of the statute.

"LPN" next asserts that "treatment of the partnerships as members of the "LPN" Pipeline unitary group violates the U.S. Supreme Court doctrine that a business enterprise may be combined with other business enterprises in a unitary business group only if there exists actual centralized management through majority ownership and control." "LPN" cites ASARCO v. Idaho Tax Commission, *supra*, F. W. Woolworth Co. v. Taxation and Revenue Department of New Mexico, *supra*, and Allied Signal, Inc., v. New Jersey, *supra*.

In ASARCO the income in question was dividend income from five non-U.S. corporations in which ASARCO owned a significant interest (from 34% to 53%). 458 U.S at 309 [n. 2], 313. In Woolworth, the income in question included dividend income from subsidiary corporations. 458 U.S. at 359. In Allied Signal, the income in question was gain realized on the sale of a 20.6% interest in the stock of ASARCO that Allied Signal sold. 504 U. S. at 773.

Therefore, "LPN's" reliance on these cases is misplaced. None of these cases address the question of whether a non-resident corporation's share of partnership income, which in this case is admittedly business income, should be excluded from the non-resident corporation's other business income subject to apportionment, as suggested by "LPN's" arguments. These cases involve groups of affiliated corporations. Each of these corporations is a discrete tax paying entity. "LPN's" situation involves its share of the several partnerships which are not a taxpaying entities but, rather, they are "flow through" business organizations. The Department is not treating the partnerships as members of the "LPN" unitary group. The Department is only including "LPN's" share of its partnership income in "LPN's" business income because it is stipulated as being business income.

Furthermore, all three of the cited cases involved the question of whether income was business income apportionable to the various states in which the taxpayer operated or non-business income allocable to the state in which the taxpayer maintained its commercial domicile. ASARCO, Inc., 458 U.S. at 309-311; F. W. Woolworth, Co., 458 U.S. at 357, 358; Allied Signal, Inc., 504 U.S at 776. As noted previously, the parties stipulated in this case that the income "LPN" received from the partnerships was business income and that "LPN" and the partnerships are in the same line of business, the "pipeline" business. There is no issue regarding whether the "LPN's" share of the partnership income is business or non-business income.

The U. S. Supreme Court address a situation similar to the instant case in Mobil Oil

Corp. This regulation was in effect when the legislature amended IITA § 305 in 1985 (Public Act 84-850) without any change in the Department's position as reflected in that regulation., *supra*. Mobil engages in an integrated petroleum business, ranging from exploration for petroleum reserves to production, refining, transportation, and distribution and sale of petroleum and petroleum products. It also engages in related chemical and mining enterprises. It does business in over 40 states and the District of Columbia as well as in foreign countries. Mobil Oil Corporation, 445 U. S. at 428. Mobil conducts its business through wholly and partly owned corporate affiliates some of which are incorporated in foreign countries and others that are incorporated in states other than Vermont. *Id.* None of Mobil's affiliates conducts business in Vermont. *Id.* Mobil had less than a 50% ownership interest in its affiliates. *Id*. at n. 1.

Vermont assessed corporate income tax on an apportioned part of Mobil's total income which included dividend income received from foreign subsidiaries and affiliates. *Id.* at 430, 431. Mobil's only business activity in Vermont consisted of wholesale and retail marketing of petroleum products. *Id.* Vermont's income tax statute employed a three factor apportionment formula similar to the one employed in the IITA.

The Court first found that the dividend payers engaged in business activities that form part of Mobil's integrated petroleum enterprise. *Id.* at 435. The Court then noted that it held in prior cases that due process requirements are satisfied if the taxpayer's activities in and out of state that produced the income form part of a unitary business. *Id.* at 438. The court went on to state that "the linchpin of apportionability in the field of state income taxation is the unitary business principal. In accord with this principle, what the [taxpayer] must show, in order to establish that its dividend income is not subject to an apportioned tax in Vermont, is that the income was earned in the course of activities unrelated to the sale of petroleum products in that State." *Id.* at 439. The Court stated that as long dividends from subsidiaries and affiliates consist of profits earned by a functionally integrated enterprise, the dividends are income to the parent earned in a unitary enterprise. *Id.* at 440. Finally, the Court held that Mobil had not shown that the taxation of the dividends by Vermont was prevented as a matter of due process. *Id.* at 442.

Although Mobil involved dividends from foreign subsidiaries and uncontrolled foreign affiliates rather than shares of partnership income, the principles the court applied to find that the dividends from uncontrolled affiliates were apportionable business income are applicable to this case as well. "LPN" and the partnerships are engaged in business activities that form part of "LPN's" integrated petroleum enterprise. The parties stipulated that "LPN" and the partnerships are in the same pipeline business of transporting crude oil by pipeline in the United States, including Illinois and Alaska. "LPN" participates in the management of the partnerships. The activities of "LPN" and the partnerships constitute an integrated petroleum transportation enterprise. In Mobil, the fact that Mobil did not control the foreign affiliates did not bar the inclusion of their dividends in Mobil's business income because those subsidiaries were part of Mobil's integrated business. Similarly, the fact that "LPN" does not own a controlling interest in the partnerships is not a bar to including "LPN's" share of the partnership income in its apportionable income base because the record establishes that "LPN's" partnership shares are part of "LPN's" integrated pipeline transportation business. As was the case in Mobil, "LPN" has failed to show that the activities of the partnerships were unrelated to "LPN's" business activities in Illinois.

"LPN's" final argument is that "'The water's edge' legislation (Public Act 82-1029) is unconstitutional under the Illinois Constitution of 1970, because Governor Thompson exceeded the bounds of his amendatory veto power in connection with such legislation. "LPN" argues that the Governor used his amendatory veto to eliminate the substance of House bill 2588 and to insert in the IITA the provisions providing for the water's edge method of unitary taxation.

With regard to this argument, it must first be noted that administrative agencies have no authority to invalidate statutes on constitutional grounds or to question their validity. Moore v. City of East Cleveland, 431 U.S. 494, 497 n. 5. (1977); Texaco-Cities Service Pipeline Co. v. McGaw, 182 Ill.2d at 278. Therefore, I have no authority to rule on the validity or constitutionality of the statute.

Be that as it may, I can recognize precedents that hold that statutes are presumed to be constitutional. General Telephone Co. v. Johnson, 103 Ill. 2d 363 (1984), Geja's Cafe et al., v. Metropolitan Pier and Exposition Authority, 153 Ill.2d 239 (1992). I can also note that Section 9(e) of Article IV of the 1970 Illinois Constitution provides:

> The Governor may return a bill together with specific recommendations for change to the house in which it originated. The bill shall be considered in the same manner as a vetoed bill but the specific recommendations may be accepted by a record vote of a majority of the members elected to each house. Such bills shall be presented again to the Governor and if he certifies that such acceptance conforms to his specific recommendations, the bill shall become law. If he does not so certify, he shall return it as a vetoed bill to the house in which it originated.

The extent of the Governor's amendatory veto power under section 9(e) is not limited to correcting technical errors. However, at the other end of the spectrum, the Governor's amendatory veto power does not include the power to substitute a completely new bill. Continental Illinois National Bank and trust Company of Chicago v. Zagel, 78

Ill.2d 387 (1979). The courts have not yet set the precise limit between these two extremes at which the Governor would cross over the limit. People ex rel. City of Canton v. Crouch, 79 Ill.2d 356 (1980). "LPN" alleges that the governor overstepped his authority in the case of Public Act 82-1029, but has offered no evidence to support that conclusion. Therefore, "LPN" has failed to clearly establish that the governor's actions in amending House Bill 2588, which became Public Act 82-1029, were unconstitutional.

For the reasons set forth above, I recommend that the Department's Notice of Denial of part of "LPN's" refund claims be made final.

ENTER: January 13, 2000

____

Administrative Law Judge